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LABOR FOR ILAB, TMCCARTER, LBUFFO, CROMERO

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SUBJECT: PERU AMONG WORLD'S MOST INFORMAL ECONOMIES

REF: LIMA 3778

1. Summary: The World Bank ranks Peru as the world's fifth most informal economy. In urban Peru, nearly 70 percent of workers (62 percent in Lima) are employed informally, the third highest rate in Latin America. Bureaucratic barriers largely account for Peru's informality, generating problems such as tax evasion, low productivity, and poor working conditions. The GOP sought to reduce informality through legislation approved in July 2003, but it has achieved little progress. The GOP views the U.S.-Andean FTA as a tool to reduce informality and generate more export-oriented employment. End Summary.

High Informality in Urban Centers

2. The Ministry of Labor's most recent report on national labor market informality reveals that Peru possesses the third highest rate in Latin America, behind Bolivia and Panama. In its 2002 National Household Survey, the Labor Ministry reports 69 percent of all workers in urban Peru are employed informally. The Ministry defines informal workers as: employees of unregistered businesses, workers without remuneration, untrained independent workers, and domestic employees. In 2003, the World Bank listed Peru as one of the leaders in informal employment worldwide, ranking it fifth, with 60 percent informality (no definition for informality was provided).

3. In Metropolitan Lima, 62 percent of all employment qualifies as informal, according to INEI, Peru's Statistical Organization. The 1.3 million independent workers (domestic workers, taxi drivers, and food vendors, among others) account for 57 percent of the informal workforce, 279,000 of whom are street vendors. Enterprises employing between two and four workers account for another 39 percent of the informal workforce. Nearly all informal workers are employed by microenterprises, which employ less than ten workers. The young bear the burden of informality. Those between 11 and 24 years old make up 26 percent of the economically active persons, yet account for about half of informal workers.

4. An even higher incidence exists in the urban areas outside of Lima, where informality accounts for 74 percent of the workforce. Single worker enterprises occupy 50 percent of the 3.2 million informal jobs existing in these areas. Another 44 percent work for enterprises employing between two and four people. Just as in Lima, micro enterprises account for nearly all informality.

Costly to Join Formal Economy

5. Despite Peru's positive macroeconomic growth, formal job creation has lagged. Bureaucratic barriers are largely responsible for the long delays and high costs in establishing a formal business. In Peru it takes a minimum of 98 days and costs \$778 (36 percent of per capita income) to start a business, according to the World Bank. Business leaders often complain that Peru's labor laws are too burdensome and costly, creating incentives for small enterprises not to join the formal economy. Employers that adhere to the high-standard labor legislation find that 64 percent of their labor expenses are non-salary related.

6. The Labor Ministry indicates that 41 percent of workers participate in the informal sector because they could not find other work, whereas 50 percent participate by choice. The most prominent reason why people choose to work informally is the opportunity to make more money, followed by the desire to work independently. Given the option, informal one-worker enterprises and microenterprises prefer not to pay taxes and cover the relatively high costs of being formal. Many business leaders argue that by implementing a more flexible labor code and streamlining registration bureaucracy, Peru would attract more private investment and increase the size of the formal economy.

Legislative Fix Fails to Reduce Informality

17. Congress passed Law 28015 in July 2003, with the objective of reducing barriers to the formal economy and simplifying the registration process for microenterprises. Unfortunately, then-Labor Minister Fernando Villaran, the main promoter of the law, left his office just as it passed congress, and the four subsequent Ministers have not made its implementation a priority.

18. The negative effects of informality are extensive, reaching both the demand and supply side of the labor market. The visible effects of Peru's high informality include: the inability to collect income taxes from nearly 70 percent of workers, no tax revenue from informal businesses, low workforce productivity (down 40 percent from 1975), and unregulated and poor working conditions. Without job security, workers in the informal sector often receive less than minimum wages and no benefits.

Comment: FTA Promotes Formality

19. A recent proposal by Labor Minister Juan Sheput to reduce labor market rigidity has met stiff opposition from labor unions and some political parties (Reftel). While many in the GOP understand the problems affecting Peru's labor market, forward action is unlikely during an election year. Nevertheless, the GOP views the U.S.-Andean Free Trade Agreement (FTA) as a tool to stimulate reform and create new export-related employment -- a key element for moving Peru's workforce into the formal economy.

POWERS